No. 9902

In the United States Circuit Court of Appeals for the Ninth Circuit

Golden State Theatre & Realty Corporation, a California Corporation, petitioner

v.

Commissioner of Internal Revenue, respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The memorandum opinion of the Board of Tax Appeals (R. 9–10) is not reported.

JURISDICTION

The petition for review involves income taxes for the year 1936 in the amount of $15,562.51 and is taken from the decision of the Board of Tax Appeals entered March 28, 1941. (R. 11.) A motion for reconsideration, review by the entire Board, and in the alternative for a rehearing was filed April 28, 1941. Review by the entire Board was denied by an order entered April 29, 1941, and reconsideration and rehearing was denied by an order entered May 3, 1941.

(R. 11–12.) The case is brought to this Court by petition for review filed July 16, 1941 (R. 12–17), pursuant to the provisions of Section 1141–1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether the transfer to taxpayer from its wholly-owned subsidiary of 4,397 shares of taxpayer's stock owned by the subsidiary was a dividend under Section 115 of the Revenue Act of 1936.

STATUTES AND REGULATIONS INVOLVED

The pertinent portions of the statute and regulations involved are set forth in the Appendix, *infra,* pp. 13–15.

STATEMENT

The facts as stipulated by the parties (R. 19–34) may be summarized as follows:

The taxpayer is a California corporation having its principal place of business in the City of San Francisco. From January 2, 1930, up to and including the date of hearing of this case before the Board, the taxpayer owned all of the issued and outstanding stock of San Francisco Wigwam Theatre Company, also a California corporation with its principal place of business in San Francisco. (R. 20–21, 29.) On July 8, 1931, the subsidiary purchased 2,500 shares of the taxpayer's capital stock from Victoria Mariani for $25,000, and on October 2, 1931, purchased 2,530 shares of the taxpayer's stock from Cecil B. DeMille Productions, Inc., for $30,935. On the latter date it sold 633 shares of such stock to David Bolton for $7,733.75. (R. 21–22.) On September 30, 1931, R. A. McNeil, a

vice president of the taxpayer, was paid a commission of $2,500 by the subsidiary in connection with the purchase of the 2,500 shares from Victoria Mariani, which amount McNeil on January 18, 1937, paid to the taxpayer. The $2,500 paid by McNeil to the taxpayer was credited to the latter's earned surplus account. (R. 22.) The cost of the 4,397 shares of taxpayer's stock to the subsidiary was $50,701.25, including McNeil's commission. (R. 22.)

On October 8, 1931, the certificates representing the 4,397 shares purchased from Victoria Mariani and Cecil B. DeMille Productions, Inc. were canceled and new certificates issued in the name of San Francisco Wigwam Theatre Company, the subsidiary. On December 15, 1936, the certificates standing in the name of the subsidiary were canceled and new certificates issued in the name of Golden State Theatre & Realty Corporation, the parent. (R. 22–23.)

The 4,397 shares in question were carried until December 31, 1936, by the subsidiary as an asset in its stocks and bonds account. On that date a charge of $50,701.25 was made to the earned surplus account of the subsidiary and a corresponding credit made in the stocks and bonds account. (R. 23.) The parent, on April 3, 1937, made entries in its books by which it set up the treasury stock as an asset in the amount of $43,970 and transferred an equivalent amount to capital surplus. On January 2, 1938, the entries made in the preceding year were reversed to the extent that instead of crediting capital surplus, a special item designated "Donated Surplus Treasury Stock" was set up. (R. 23–24.)

The minutes of the meeting of the board of directors of San Francisco Wigwam Theatre Company, the subsidiary, at which the transfer of the shares in question to the parent was authorized, state in part (R. 33):

> The president then stated that this corporation is the owner of 4397 shares of the capital stock of Golden State Theatre & Realty Corporation, which last named corporation owns all of the issued and outstanding stock of this corporation, with the exception of the qualifying shares held by the directors. He stated that in his opinion it is advisable for this corporation to donate said 4397 shares of stock of said Golden State company to the latter corporation and he asked the consideration of the directors with respect to the proposal. Upon motion of Director M. Naify, seconded by Director McNeil, the following resolution was then passed without dissenting voice:
>
> Resolved, that this corporation convey to Golden State Theatre & Realty Corporation 4397 shares of the stock of the last named corporation now owned by this corporation and that if in the judgment of this corporation's accountant said transaction should be so handled, said conveyance be by way of a donation made by this corporation to said Golden State Theatre & Realty Corporation.

In its income tax return for the year 1936, taxpayer did not include as dividends received any value for the 4,397 shares in question. By letter dated December 5, 1939, the Commissioner of Internal Revenue asserted a deficiency in taxpayer's income tax for the year 1936 of $15,562.51 resulting from the inclusion in net income of $11,240 received as cash dividends,

and $65,295.45, the asserted fair market value of the 4,397 shares of stock received from the subsidiary. (R. 25–29.)

The Board of Tax Appeals held that the transfer of the shares was a dividend under Section 115 of the Revenue Act of 1936 and that the Commissioner's determination was therefore correct. (R. 9–10.)

SUMMARY OF ARGUMENT

The taxpayer received 4,397 of its own shares in the nature of a dividend from its wholly-owned subsidiary. This was income to petitioner in the amount of the fair market value of the stock for to that extent the claims against the corporation were reduced and the interest of the remaining shareholders was increased.

The situation is just as though the subsidiary had declared a cash dividend equivalent to the fair market value of the stock and the taxpayer had then purchased the shares itself. Such a cash dividend would be income to petitioner. A dividend in its own stock or any other property is no less income.

The parent-subsidiary relationship does not alter the character of the transaction.

ARGUMENT

I

The distribution by a subsidiary to a parent of the latter's own shares results in income to the parent

During the year 1936, the taxpayer received from its wholly-owned subsidiary 4,397 shares of its own stock which the subsidiary had acquired from the

public. The taxpayer paid no consideration for the shares. It is the Commissioner's position that as a result of this acquisition the taxpayer received income in the nature of a dividend equivalent to the fair market value of the shares on the date of the transfer. The taxpayer concedes the accuracy of the valuation of the stock; the sole question raised is as to whether it realized income from the acquisition of its own shares.

The decisions are numerous and uniform that a corporation may realize income from the acquisition of its own shares notwithstanding the fact that good accounting practice probably requires that such shares when acquired by the issuer be not treated as assets but rather as affecting a reduction in capital.[1] *Commissioner* v. *S. A. Woods Mach. Co.*, 57 F. (2d) 635 (C. C. A. 1st); *Commissioner* v. *Boca Ceiga Development Co.*, 66 F. (2d) 1004 (C. C. A. 3d); *Dorsey Co.* v. *Commissioner*, 76 F. (2d) 339 (C. C. A. 5th); *Allyne-Zerk Co.* v. *Commissioner*, 83 F. (2d) 525 (C. C. A. 6th); *Horn & Hardart Baking Co.* v. *United States*, 34 F. Supp. 89 (E. D. Pa.). See also *E. R. Squibb & Sons* v. *Helvering*, 98 F. (2d) 69 (C. C. A. 2d).

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[1] Discussions as to the correct manner of handling treasury stock are numerous and while most accountants are in agreement that treasury stock should not be treated as an asset, they recognize that as a practical matter it is frequently carried as such. See, for example, Hills, Stated Capital and Treasury Shares, 57 Jour. of Accountancy 202 ff.; Marple, Capital Surplus and Corporate Net Worth, c. 5, p. 53; Marple, Treasury Stock, 57 Jour. of Accountancy 257 ff.

Each of these cases involved the acquisition by a corporation of its own shares either in exchange for assets having less value then the shares or as in the *Woods* case, *supra,* in satisfaction of a claim, the cash payment of which would have been income. In each case the court held that all or such part of the shares as exceeded the cost to the corporation of the assets given in exchange for them was income, for to that extent the remaining shareholders were enriched. In the language of the opinion in the *Squibb* case, *supra* (p. 71):

> In both situations the remaining shareholders are enriched by the full present value of the shares; and this is a part income, *or all income,* according as the consideration given in exchange had or had not any "basis". [Italics supplied.]

The application of the principles enunciated in the foregoing cases to the present situation is apparent. Here, the taxpayer received its own shares without giving any consideration therefor. Clearly, if the subsidiary had declared a cash dividend equivalent to the fair market value of the taxpayer's shares in question, the receipt thereof would have been income. But the benefit to the taxpayer here was the same, for to the extent that the number of shares outstanding was reduced the interest of the remaining stockholders was enhanced just as the receipt of any other income would have increased the value of their shares.

The present situation, that of a corporation realizing income on the *acquisition* of its own shares, should not be confused with its converse, the *sale* by a corporation

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of its own shares at more than par or the *sale* of treasury shares for more than was paid for them. The rule in such cases appears to be that the excess is merely additional capital. *Helvering* v. *Reynolds Co.*, 306 U. S. 110; *E. R. Squibb & Sons* v. *Helvering, supra.* In this connection it should be noted that the Treasury Regulations since 1933 recognized that even in this situation a corporation dealing in its own shares on a commercial basis, as it might in the shares of another corporation, i. e., buying and selling regularly, may realize taxable income or suffer a deductible loss. Treasury Regulations 77, Article 66, Appendix, *infra.*

Where, however, the corporation acquires its own shares for less than their value, the many decisions are uniform that it realizes income to the extent of the difference between the consideration paid and the value of the shares. Since in the instant case, the taxpayer paid nothing for the 4,397 shares acquired from the subsidiary, the entire value of such shares was, as the Commissioner and the Board have found, income to it.

As a practical matter the situation is just as though the subsidiary had declared a cash dividend equivalent to the value of the shares and the taxpayer had used the cash to purchase them. Had that been done there can be no question but that the taxpayer would have received taxable income in the amount of the cash dividend. It received no less here.

In connection with this analogy, the opinion in the *Woods* case, *supra*, is particularly appropriate. The corporation there had acquired its own shares in satisfaction of a debt owed it by the stockholder, the pay-

ment of which in cash would have been income. The court said (p. 636):

> The transaction involved in this case was equivalent to the payment of the debt in cash and the investment of the proceeds by the corporation in its own stock. If that had been done clearly the cash received would have been taxable income. The transaction was not changed in its essential character by the fact that, as the debtor happened also to own the stock, the money payment and the purchase of stock were bypassed, and the stock was directly transferred in payment of the debt. The stock was the medium in which the debt was paid. The wide door to evasion of taxes opened by the decision of the Board is an additional reason, and a weighty one, against it.

The possibility of evasion is, of course, equally present here, for the subsidiary had the alternative of declaring a cash dividend which the taxpayer might have used to purchase the shares or of acquiring the stock and subsequently transferring it rather than the cash. It did the latter. There is no difference in result; the taxpayer received income equal to the fair market value of its stock on the date of the transfer.

II

The parent-subsidiary relationship does not alter the character of the transaction

The taxpayer has predicated its entire argument on an assumption that the acquisition of the shares by the subsidiary and the subsequent transfer of them to petitioner is no different in substance than had peti-

tioner itself purchased the shares. On this assumption it has urged that the stock in the hands of the subsidiary was treasury stock and valueless. The fallacy of this argument is obvious. The subsidiary was a separate corporate entity. It had its own creditors. There can be no doubt that the taxpayer's stock in the subsidiary's hands was an asset to which the latter's creditors would have been entitled to look for satisfaction of their claims. Petitioner's shares had as much value in the subsidiary's possession as in the hands of any other stockholder.

Considerable space is also devoted in the taxpayer's brief to the contention that since, under the applicable California statutes, treasury shares may not be considered as assets, no income can result to a corporation from the acquisition of its own stock. The decisions heretofore referred to are a complete answer to this contention for they recognize that while better accounting practice is not to treat treasury shares as assets, notwithstanding this fact a corporation realizes income when it acquires its own shares for less than their value.

Moreover, Section 342 (b) of the California Civil Code merely provides that treasury stock "shall not be counted as * * * assets for the purpose of computing a surplus available for dividends or the purchase of shares issued by the corporation, or the making of any other distribution to its shareholders." Thus the limitation is a narrow one. It does not preclude the resale of the treasury stock and does not affect its market value. Accordingly, the stock is an asset for tax purposes.

This is not the only situation in which income may be realized although the thing received is not strictly speaking an asset in the hands of the recipient. The so-called "cancellation of indebtedness" cases are a pertinent example, for it is well settled that when a solvent individual or corporation obtains a forgiveness or cancellation of indebtedness, the entire amount in the case of forgiveness, or the difference between the indebtedness and the amount paid to obtain the cancellation, is income to the debtor notwithstanding the fact that the notes or other evidence of indebtedness are not an asset in the debtor's hands. *United States* v. *Kirby Lumber Co.,* 284 U. S. 1; *Helvering* v. *Amer. Chicle Co.,* 291 U. S. 426; *Helvering* v. *Jane Holding Corp.,* 109 F. (2d) 933, 940 (C. C. A. 8th); *Haden Co.* v. *Commissioner,* 118 F. (2d) 285, 286 (C. C. A. 5th).

Finally, the taxpayer has urged that the substance and not the form of the transaction should control. This argument also assumes that the separate corporate entities may be ignored. There is, however, no justification here for treating the taxpayer and its subisidiary as a single corporate entity. They were not in fact, and so far as the record indicates, they operated entirely separately. Cf. *Burnet* v. *Clark,* 287 U. S. 410; *Burnet* v. *Commonwealth Imp. Co.,* 287 U. S. 415. In any event, a taxpayer may not, in an effort to avoid taxes, ignore corporate entitles of its own creation. See *Higgins* v. *Smith,* 308 U. S. 473, 477.

The form and the substance here are the same. The taxpayer's subsidiary transferred to its parent in the

nature of a dividend certain of the latter's shares. Petitioner received taxable income therefrom just as it would have had the dividend been payable in cash or other property.

CONCLUSION

The decision of the Board of Tax Appeals is correct and should be affirmed.

Respectfully submitted,

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November, 1941.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 13. NORMAL TAX ON CORPORATIONS.

(a) DEFINITION.—As used in this title the term "normal-tax net income" means the net income minus the sum of—

*   *   *   *   *

(2) DIVIDENDS RECEIVED.—The credit provided in section 26 (b). Such credit shall not be allowed in the case of a mutual investment company, as defined in section 48.

*   *   *   *   *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

*   *   *   *   *

(b) DIVIDENDS RECEIVED.—85 per centum of the amount received as dividends from a domestic corporation which is subject to taxation under this title. The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, or from a corporation which under section 251 is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States.

*   *   *   *   *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) DEFINITION OF DIVIDEND.—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating

to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

(j) VALUATION OF DIVIDEND.—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 115–10. *Dividends paid in property.*—If the whole or any part of the dividend is paid to a shareholder in any medium other than money, the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder. (See article 42–3.) Scrip dividends are subject to tax in the year in which the warrants are issued.

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 66 [as amended by T. D. 4430, XIII–1 Cum. Bull. 36]. *Acquisition or disposition by a corporation of its own capital stock.*—Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss

depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.

But where a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of applicable statutes.

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